BRANCH OIL & GAS CO.

IBLA 95-699 Decided June 17, 1998

Appeal from a Decision of the Associate Director for Policy and Management Improvement, Minerals Management Service, affirming Demand Letter to pay additional royalties on onshore natural gas production. MMS-92-0030-O&G.

Affirmed.

1. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties: Generally

When there is no market for ungathered/uncompressed natural gas at the wellhead and the initial purchaser gathers, compresses, and resells the gas, the royalty value of the gas produced from the lease must be based on the price received upon resale, with no deduction for the costs incurred by the purchaser to condition the gas for resale.

APPEARANCES: Gary G. Broeder, Esq., Billings, Montana, for the Branch Oil & Gas Company; Sarah L. Inderbitzin, Esq., Peter J. Schaumberg, Esq., Howard W. Chalker, Esq., Geoffrey Heath, Esq., Lisa K. Hemmer, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE KELLY

Branch Oil & Gas Company (Branch) has appealed from a June 12, 1995, Decision of the Associate Director for Policy and Management Improvement, Minerals Management Service (MMS), denying its appeal from a November 7, 1991, Order of the Chief, Office of State and Tribal Program Support (OSTPS), Royalty Compliance Division, MMS, requiring it to pay additional royalties of $5,657.57 with respect to natural gas production from its Federal oil and gas leases, Nos. 053-027079-A and 053-027177-A, situated in Toole County, Montana. OSTPS concluded that Branch had improperly valued the natural gas for royalty purposes during the period from February 1, 1979, through June 30, 1987.

All of the natural gas at issue was sold by Branch, at the wellhead, in an ungathered/uncompressed state to the Cascade Gas Company (Cascade), under a gas purchase contract. Cascade, a corporation originally formed by Branch and other working interest owners in the same field as the two Federal leases, gathered and compressed the gas for resale to the Montana Power Company (MPC) under a separate gas purchase contract. In calculating and paying royalty, Branch based the value of the gas on the initial sales price paid under its contract with Cascade, not the resale price paid under Cascade's contract with MPC.

Based on an audit by the Montana Department of Revenue, OSTPS concluded in its Order that Branch had improperly valued the gas according to the initial sales price, rather than the resale price with no deduction for the costs incurred by Cascade to gather and compress the gas. OSTPS reasoned that, regardless of whether such costs were incurred by the lessee or by a third party on the lessee's behalf, they were properly included in the royalty value of the gas, since they were necessary to render the gas marketable.

Branch appealed from OSTPS' Order to the Director, MMS, contending that MMS was estopped from seeking payment from Branch because (1) MMS failed to collect from Cascade, the responsible payor, any amount due, (2) that MMS was barred by the statute of limitations, set forth at 28 U.S.C. § 2415(a) (1994), from collecting an additional royalties which had become due more than 6 years prior to its November 1991 Order, and (3) that the Branch-Cascade well contract price established the value of gas for royalty purposes.

In her June 1995 Decision, the Associate Director addressed each of Branch's arguments, concluding that OSTPS had properly determined that Branch owed additional royalties based on a proper valuation of the gas produced from its leases. Branch appealed her Decision to the Board.

In its Statement of Reasons (SOR), Branch contends that, in determining the fair market value of the natural gas produced from its Federal leases at the wellhead, MMS improperly concluded that the market for the gas was determined by the subsequent resale from Cascade to MPC downstream of the wellhead, rather than the initial sale from Branch to Cascade at the wellhead. It maintains that it properly valued the gas according to the "actual fair market value of the [gas] at the wellhead," i.e., the initial sales price received by it under its purchase contract with Cascade, with no deduction for its own marketing expenses. (SOR at 4.) Branch asserts that MMS improperly required it to value the gas according to the subsequent resale price received by Cascade under its purchase contract with MPC, thus requiring it to include the expenses incurred by Cascade to gather and compress the gas for the purposes of that resale. Branch argues that MMS' requirement does not comport with applicable case law, citing California Company v. Udall, 296 F.2d 384 (D.C. Cir. 1961) and Shoshone Indian Tribe v. Hodel, 903 F.2d 784 (10th Cir. 1990).

Branch also asserts that any doubt regarding whether the sales price received from Cascade represented an arm's-length contract price was dispelled by the fact that it was "equal to or greater than the price being paid to any other producer for like quality gas produced in the same field." (SOR at 3.) Thus, it argues that the sales price comported, in two important respects, with the requirements of 30 C.F.R. § 206.103 (1987), which provides that due consideration be given to the price received by the lessee and the highest price paid for like quality production from the same field. By contrast, Branch avers, MMS not only failed to take these factors into consideration, but required Branch "to pay royalty upon a value of the production which Branch never received and was never entitled to receive pursuant to the terms of the Branch/Cascade gas purchase agreement." (SOR at 4.)

[1] It is well established that MMS has considerable latitude, under 30 U.S.C. § 226(b) (1994) and Departmental regulations, in determining the proper value of production, from Federal oil and gas leases, for royalty purposes. Hoover & Bracken Energies, Inc., 52 IBLA 27, 33 (1981), rev'd, Hoover & Bracken Energies, Inc. v. U.S. Department of the Interior, No. 81-461-T (W.D. Okla. Nov. 18, 1981), rev'd, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984). During the relevant time period, Departmental regulations broadly stated that the value of production

> shall be the estimated reasonable value of the product as determined by [MMS] due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters.

30 C.F.R. § 206.103 (1987).

It is also well established that a lessee is required to place natural gas produced from Federally-leased lands in a marketable condition, including gathering and compressing it, at no cost to the Federal Government. 30 C.F.R. § 206.106(b) (1987); 43 C.F.R. § 3162.7-1(a) (1987); Mesa Operating Limited Partnership v. U.S. Department of Interior, 931 F.2d 318, 324-25 (5th Cir. 1991), cert. denied, 502 U.S. 1058 (1992). Thus, where the lessee incurs the costs of gathering and compressing the gas in order to place it in a marketable condition, it may not deduct such costs from the sales price for the purpose of royalty valuation. Shoshone Indian Tribe v. Hodel, 903 F.2d at 788.

Moreover, a lessee remains obligated for such costs where it sells the gas to a purchaser which gathers and compresses it to place it in a marketable condition for resale. R.E. Yarbrough & Co., 122 IBLA 217, 218, 220-21, 223 (1992). That is the case here. It is well settled that natural gas produced from Federal leases may be valued for royalty purposes according to the price received on the subsequent resale of the gas, where the gas initially sold was not conditioned for market. R.E. Yarbrough & Co., 122 IBLA at 223.

In the present case, there is no evidence that the gas could have been marketed at the wellhead in its ungathered/uncompressed state. Rather, Branch admitted in its initial appeal that the gas would not have sold but for the fact that it was sold to a company affiliated with the seller (Cascade), which then gathered and compressed it before selling it to MPC:

> After discovery of the natural gas reserves, [Branch] and the other operators in the area approached the only end user pipeline company in the area, The Montana Power Company ("MPC"), concerning wellhead gas purchase contracts for the gas. MPC was buying like quality gas from similar wells under wellhead gas purchase contracts from certain other operators in the general vicinity. In this instance, however, MPC's response was that it considered the volumes of gas too small and the reservoir pressures too low to justify risking the capital necessary to construct the gathering lines and gas plant which were necessary to gather, dehydrate and compress the gas. Thus, no market existed for the gas in question.
>
> MPC did advise [Branch] and the other operators that, if they, or some part of the operators, were willing to risk the capital to construct the gathering lines and gas plant, MPC would be willing to purchase the gas at the downstream end of the gas plant under a delivered gas purchase contract. While many of the operators in the area were unable or unwilling to risk the capital necessary to create a market for the gas, [Branch] and certain other parties thereafter formed a corporation, Cascade Gas Company ("Cascade"), and invested in excess of $1,500,000.00 to construct the gathering system and gas plant. * * * The high risk capital investment by Cascade created a market for the gas in the area in question.

(SOR (MMS-92-0030-O&G) at 1-2 (emphasis added).)

Before the Board, Branch asserts only that it could effect delivery of the gas to Cascade without gathering/compressing the gas. Delivery and even a sale of gas do not establish that the gas could have been marketed in its ungathered/uncompressed state. See Texaco Inc., 134 IBLA 109, 115 (1995). Branch does not dispute the fact that (other than Cascade) it did not have a market for the gas in that state. Cascade, however, did not represent a true market. As we recently stated, in identical circumstances, in Branch Oil & Gas Co., 143 IBLA 204, 206-07 (1998):

> [A] market for [ungathered/]uncompressed gas can be said to exist only where there is an "established demand" for that gas. California Co. v. Udall, 296 F.2d at 388. * * * [Cascade] cannot represent that an established demand for that gas existed when the evidence shows that Branch and others created [Cascade] for the specific purpose of buying and then marketing what was otherwise unmarketable gas. See Xeno, Inc., 134 IBLA 172, 183 (1995).

Further, it is undisputed that gathering/compressing the gas was necessary in order to market the gas to MPC, which represented the established demand for the gas.

Thus, we find that Branch's gas was not in a marketable condition when it emerged from the wellhead; it was marketable only after the gas was gathered and compressed. As indicated above, the fact that this function was performed by Cascade and not Branch does not affect whether the costs of doing so are properly borne by the lessee and included in the royalty value of the gas. See R.E. Yarbrough & Co. 122 IBLA at 221. Therefore, we conclude that MMS properly used the resale price for the gas, with no deduction for the costs incurred to gather/compress it, rather than its initial sales price.

Branch next argues that MMS is estopped to pursue the collection of additional royalties from it because MMS had failed to properly seek such payment first from the responsible payor. Branch maintains that Cascade is that payor and that MMS declined to pursue it, erroneously believing that, since its corporate structure had been involuntarily dissolved by the State of Montana in 1989, MMS could not seek payment from it. Branch asserts Cascade, which was still in existence under State law for purposes of winding up its corporate affairs, was properly responsible for the payment of all of the liabilities it had already incurred, including its Federal royalty obligation. Branch concludes that it should be held accountable only if Cascade is found liable for the claim and is unable to pay it.

We reject Branch's contention that MMS was required to pursue the collection of additional royalties first from Cascade. We find no authority to that effect, nor does Branch cite any. As the Associate Director properly found, Branch, as the Federal lessee, is ultimately responsible for the payment of any and all royalties that came due as a result of the production of natural gas from its lease. 43 C.F.R. § 3162.3(a) (1987); Jerry Chambers Exploration Co., 107 IBLA 161, 163 (1989). Thus, MMS was clearly entitled to pursue Branch for the collection of any additional royalties later determined to be due.

Finally, Branch contends that MMS is barred by 28 U.S.C. § 2415(a) (1994), from pursuing administrative claims for additional royalties that became due more than 6 years prior to OSTPS' November 1991 Order demanding payment of such royalties.

The Associate Director properly found that MMS is not barred from determining the lessee's underlying liability and otherwise pursuing an administrative claim for additional royalties even where, at the time of OSTPS' November 1991 Order, more than 6 years had elapsed since the production occurred and the royalties became due. That has been the longstanding holding of the Board, and it has not been overturned by any Federal court. See Texaco Exploration & Production, Inc., 140 IBLA 282, 284-85 (1997). We find nothing to the contrary in Phillips v. Lujan, 4 F.3d 858 (10th Cir. 1993), cited by Branch.

To the extent Branch has raised arguments not addressed herein, they have been considered and rejected.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, the Decision appealed from is affirmed.

John H. Kelly
Administrative Judge

I concur:

James L. Burski
Administrative Judge